Decision **DRAFT DECISION OF COMMISSIONERS PEEVEY AND KENNEDY)**
(Mailed 9/28/2005)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Rules to Ensure Reliable, Long-Term Supplies of Natural Gas to California.	Rulemaking 04-01-025 (Filed January 22, 2004)

ORDER MODIFYING DECISION 04-01-047 IN RESPONSE TO THE PETITION OF THE PACIFIC GAS AND ELECTRIC COMPANY

Summary

In response to events stemming from Hurricane Katrina and the rising natural gas prices for this winter and in following years, on September 13, 2005, Pacific Gas and Electric Company (PG&E) filed a petition requesting that the Commission authorize, on an emergency basis, a modification of Decision (D.) 04-01-047.[1] That decision, among other things, approved the current version of PG&E's Core Procurement Incentive Mechanism (CPIM). PG&E argues that emergency action is needed to protect its core gas customers from natural gas price spikes in the coming winter and in subsequent winters because the recent events highlight the market's inherent volatility and susceptibility to sudden and sustained price spikes due to events such as Katrina, due to the fundamentally tight supply-demand balance.

[1] That decision was in Rulemaking (R.) 02-06-041. PG&E served its petition on the parties to that proceeding.

Core customers are residential, small business and other customers that have elected to purchase natural gas from PG&E. The CPIM rewards or penalizes PG&E based on its success or failure in keeping its purchases of gas for core customers at or below a monthly market benchmark price. PG&E asserts that the requested modification would allow the company to undertake an expanded level of hedging of its natural gas purchases on behalf of its core gas customers. Hedging is a form of price insurance that, in this case, would guarantee that the price exposure of core customers for the hedged portion of core gas supply would not exceed a certain level. As is true with all insurance, there is a cost involved in obtaining this protection, but we believe the benefits in this instance outweigh those costs.

The day after PG&E filed its petition, the assigned administrative law judge issued a ruling setting an extremely expedited schedule for this matter. PG&E and other natural gas utilities had to file comments on September 19, 2005. Other parties were given two more days to file their comments, and reply comments were due September 23, 2005. Numerous parties answered the call, and provided their recommendations for ruling on PG&E's proposal.

In this decision, we approve PG&E's confidential hedging plan[2] with the slight modification as proposed by The Utility Reform Network (TURN). In doing so, we will remove the expenditures authorized today on financial hedging from PG&E's CPIM. This is important because it will allow PG&E to take on an expanded hedging program while aligning ratepayer and shareholder

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[2] This hedging plan will remain confidential as there is highly sensitive market information involved and if released, could work toward the detriment of PG&E's ratepayers.

interests. PG&E's ratepayers already may face monthly bill increases of 40% or more this year over last year's bills. In light of this, the proposal we adopt today will go a long way in moderating this potential impact on residential ratepayers by providing PG&E with additional ability to purchase insurance against price spikes. Today's authorization will result in a slight increase for average residential customer's monthly bill by approximately $2.00. Today's decision is an example of the Commission's desire to take whatever reasonable steps are needed to provide the utilities with the necessary tools they need to protect ratepayers from the potential for even higher bills.

We want PG&E and other utilities to employ hedges to the extent they are likely to be beneficial to core customers. It is critically important that the utilities have the flexibility, in the coming months, to make those hedging decisions quickly and that they not be constrained by disincentives to do so.

Background

The CPIM as approved in D.04-01-047 provides PG&E with a direct financial incentive to procure gas supplies and transportation at the lowest possible cost through the incentive of shareholder rewards or penalties based on comparisons of total gas costs to a monthly market-based benchmark. PG&E's performance is calculated annually and any incentive award or penalty is then recorded in the Core Sub-accounts of the Purchased Gas Account (PGA).

Because CPIM is linked to monthly gas price benchmarks, PG&E argues that it has limited incentive to fix the prices of natural gas for time periods beyond one year, or to expend dollars to hedge a significant portion of the company's natural gas purchases on behalf of core gas customers. PG&E does have the ability to engage in hedges to control the price risk for its ratepayers and has hedged its core gas purchases to some extent both this year and last.

What concerns the company is that if its spending on hedges (option premiums) exceeds the upper level of the applicable CPIM deadband, then its shareholders face the risk of penalty. Of course, the shareholders also face the possibility of reward if the hedges enable the company to realize a cost of gas below the monthly index price.

The Proposal

PG&E seeks support from the Commission for the company to increase its investments in hedges for gas needed this winter and in following years. PG&E points out that the CPIM covers only a 12 month period, and does not provide a mechanism for tracking multi-year hedges. Nonetheless PG&E asks the Commission to retain the CPIM, because its enactment led to the elimination of reasonableness reviews and it aligns the interests of PG&E's core gas customers and shareholders. However, to accommodate the need for additional hedging, PG&E is requesting that the following new Ordering Paragraphs be added to D.04-01-047:

> (1) To provide much-needed supplemental protection from possible dramatic natural gas price increases in the wake of Hurricane Katrina, PG&E is hereby authorized to purchase hedges in 2005. The level of the hedges and the expiration dates thereof are specified in the Gas Hedging Plan attached as a confidential Addendum to PG&E's Petition for Modification dated September 13, 2005.
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> (2) The costs associated with these approved hedges shall be paid by core customers. PG&E shall establish a specific core subaccount in the PGA to track these costs.
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> (3) All payouts associated with these hedges shall flow directly to PG&E's core gas customers in the year which the payout occurs. PG&E shall establish a specific core subaccount in the PGA to track the payouts.

(4) Neither the costs nor the payouts associated with these hedges will be shared by PG&E's shareholders.

As part of its petition, PG&E submitted a confidential hedging plan for expedited review and approval by the Commission. PG&E asked that the Commission approve the hedging plan as part of its decision granting the requested modification of D.04-01-047. Approval of the plan would authorize PG&E to spend up to a specified limit on option premiums to protect core customers from additional increases in natural gas prices over the next five winters, commencing with the coming winter of 2005-2006.[3]

PG&E proposed that the costs and benefits of these hedges be excluded altogether from CPIM calculations. Both costs and benefits would flow entirely to PG&E's core gas customers, outside the CPIM. The confidential hedging plan attached to the petition describes the hedging products and the annual volumes to be hedged.

PG&E specifically requested that the expanded hedging authority be extended to include, not just the coming winter of 2005-2006, but also the subsequent four winters, and that this expansion of PG&E's hedging authority over the next five years is warranted by the exigent circumstances in the wake of Hurricane Katrina. PG&E states that it also intends to propose, via a separate

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[3] As an alternative to its preferred multi-year approach, PG&E also proposes, in Part V.B, below, a one-winter hedging authorization, limited to the coming winter (2005-2006) only. This alternative would defer to a future Application the issue of protecting PG&E's core gas customers against increased prices in succeeding winters (after 2005-2006). Although PG&E presented and supports the alternative, one-year proposal, PG&E urged the Commission to adopt the multi-year approach as being in the best interests of PG&E's core gas customers.

application to be filed within the next several weeks, a more comprehensive, long-term hedging plan for the winters after 2005-2006.

PG&E argues that adoption of the current hedging proposal would require only one relatively minor, one-time modification. PG&E seeks authority to change the CPIM accounting procedures to allow PG&E to exclude option premiums and any other related hedging costs associated with the supplemental hedging plan from the CPIM. PG&E would establish separate Core Sub Accounts in the PGA to track the costs and payouts associated with the purchase of hedging instruments under this plan. All costs and payouts from the hedges authorized in the supplemental hedging plan would accrue directly and entirely to core customers. In contrast to the treatment of hedges under the CPIM, shareholders would bear no costs and receive no benefits associated with the hedges. PG&E shareholders also would forego any reward for the 2004-2005 CPIM year (Year 12). All other aspects of the CPIM would remain unchanged.

Finally, PG&E wishes to emphasize that the Company by this Emergency Petition is *not* [emphasis in original] seeking a permanent change in Commission policy, or in the CPIM, to create a long-term or large-scale hedging program. PG&E purports that it recognizes that any such change in Commission policy should receive appropriate and deliberate consideration via an application, as distinct from an Emergency Petition such as this.

The Exigent Circumstances

There is no disputing PG&E's assertion that since it hit the U.S. mainland on August 29, 2005, Hurricane Katrina has had a major adverse impact on natural gas markets, contributing to significant increases in the price of natural gas throughout the United States. Although production levels in the supply basins serving PG&E in the Southwest and in Western Canada have not been affected, natural gas supplies and futures have experienced significant price increases in the wake of Hurricane Katrina.

Hurricane Katrina struck the heart of the natural gas and oil producing region of the Gulf of Mexico and caused a major disruption in energy markets. A large proportion of offshore gas and oil production initially was shut in, and there was significant damage to the onshore infrastructure as well.[4] The upward effects on prices were immediate and significant. Gas prices for the coming winter rose above $12.00 per MMBtu (or per Dth) on the New York Mercantile Exchange (NYMEX), and created the substantial possibility of further multi-dollar per MMBtu increases due to the resulting loss of gas production.

PG&E reports that Hurricane Katrina disrupted sixteen percent of the gas production for the United States, and about seven percent remains shut in as of the date of this document. It is not yet known when and to what degree this gas production will resume.

The problems caused by Hurricane Katrina have come on the heels of several years of sustained high gas prices. Prices for natural gas already had been on an upward trajectory since early 2002. The pace of growth in demand has exceeded supply during that time, and is forecast to continue to do so for the next several years.

After the approach of Hurricane Katrina, winter natural gas prices on NYMEX rose literally overnight by twenty percent, from around $10.00 to $12.00 per MMBtu. The prices for gas in the supply areas accessed by PG&E (the U.S. Southwest and Western Canada) rose in similar proportion.

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[4] *See* Foster Natural Gas Report, Issue No. 2556 (September 1, 2005).

A further basis for concern arises from the fact that September is the peak month for hurricane activity. The hurricane season does not end until November 30. Already this year to date, there have been more named tropical storms in the Atlantic Ocean as of September 9 than as of the same date in any year in recorded history. Another hurricane in the Gulf of Mexico that affected gas supply could have a devastating upward effect on prices. Also, PG&E predicts that the current supply outage caused by Hurricane Katrina will reduce pre-winter storage inventories nationally from the previously-forecasted 3,300 billion cubic feet (Bcf), which is generally considered to be adequate for normal winter weather, to levels approaching 3,100 Bcf, or perhaps lower. This lower level of storage inventories would make it very difficult for natural gas markets to meet expected demand should there be a colder than normal winter.

Other externalities – most notably a forecast of (or the actual appearance of) below-normal winter temperatures, even in other parts of North America, as well as increases in the price of other energy commodities, such as heating oil – are also major risks that may drive natural gas prices higher.

According to recent information released by the Energy Information Administration in the U.S. Department of Energy (EIA), Hurricane Katrina also reduced natural gas production on the Gulf Coast, and slightly less than four Bcf per day of the normal 10 Bcf per day remains offline. To date, 92 Bcf of gas production has been lost. The EIA reports that several major processing plants in Louisiana are out of service due to the hurricane, and may remain out of service for as long as six months.[5]

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[5] *See* http://tonto.eia.doe.gov/oog/special/eia1_katrina_090705.html

The Administrative Law Judge (ALJ) Ruling

On September 14, 2005, the presiding ALJ issued a ruling setting an expedited schedule for review of the petition. He concluded that, since a rapid decision was needed to inform PG&E's hedging efforts this month, there was insufficient time to provide adequate consideration of PG&E's proposal for multi-year hedging. Accordingly, he directed parties to prepare comments on PG&E's secondary proposal to approve its hedging strategy only for the winter of 2005-2006. We concur with this approach. We understand PG&E's desire to begin hedging for future years, and encourage the company to do so, to the extent that, in its judgment, it is the best thing to do for core customers. However, for the Commission to fully consider and approve a multi-year approach would require an understanding of the facts supporting such a plan, as well as a review of long-term options.[6]

The ALJ also asked parties to comment on a further alternative, under which the CPIM would be suspended during this winter, and all costs would be tracked through a balancing for eventual recovery from ratepayers. All of those commenting on this proposal opposed it, largely due to the assumption that suspension of the incentive mechanism would lead, sooner or later, to the re-imposition of reasonableness reviews, a practice that was, for the most part,

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[6] We note that PG&E continues to urge adoption of its long-term hedging proposal, and that The Utility Reform Network (TURN) supports multi-year hedging in its comments. TURN would limit the plan approval to two years beyond this winter, under the assumption that liquefied natural gas (LNG) facilities will be supplying gas to California by 2008, significantly changing the natural gas picture in the state. This is just the type of factual underpinning that we must explore before approving a long-term plan.

suspended with the initial introduction of procurement incentives.[7] The ruling did not propose a return to reasonableness reviews. Parties only feared that it might.

What Other Utilities Plan to Do

As part of the expedited consideration of PG&E's proposal, the ALJ directed the San Diego Gas and Electric Company (SDG&E), the Southern California Gas Company (SoCalGas) and the Southwest Gas Company (Southwest) to file comments reflecting whether or not the Commission should act to change either their procurement practices or their incentive mechanisms for the winter of 2005-2006.

SDG&E and SoCalGas, responding jointly, support PG&E's proposal to remove the costs and benefits of hedging from the CPIM, and have ratepayers fund hedges pre-approved by the Commission. These utilities stated that they do not see a need for any changes to their current procurement practices. However, these utilities state that if the Commission wants them to acquire hedge instruments, they are willing to do so, and offer to submit detailed hedging plans for pre-approval by the Commission.

Southwest reports that it is just now gaining experience with its relatively new Gas Cost Incentive Mechanism (GCIM). The first full GCIM year begins November 1, 2005. When designing its GCIM, Southwest incorporated a Volatility Mitigation Program under which the Commission has authorized it to hedge up to 25 percent of its core gas needs. Southwest states that it had

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[7] In D.97-08-055, when the Commission approved PG&E's CPIM, the Commission was clear that it could still disallow costs if there were conflicts in interest, which motivated the utility to take actions in favor of its affiliate and contrary to its ratepayers' interests.

originally proposed a 50 percent limit, which it had reduced after negotiations with the Office of Ratepayer Advocates (ORA). The utility reports that in light of recent events, it supports the Commission authorizing Southwest to increase the percentage of hedging for its portfolio up to 50 percent.

Reactions from Other Parties

TURN, ORA, Lodi Gas Storage, Coral Energy, The School Project for Utility Rate Reduction and the Association of Bay Area Governments (SPURR/ABAG), and Accent Energy Group (Accent) all filed comments on the proposal.[8] Only TURN expresses general enthusiasm for PG&E's proposal.

ORA opposes PG&E's proposal. However, ORA recommends that if the Commission finds that PG&E has provided sufficient factual justification that the Company faces major financial penalty associated with the additional proposed hedging, and that additional protection is required from the potential of large financial penalties, the Commission should expand the tolerance band in the CPIM, instead of moving hedging outside of the mechanism. If the Commission is inclined to grant PG&E's request to remove the costs and potential benefits of its alternative hedging plan proposal from CPIM calculations, ORA recommends that the CPIM rewards be suspended for the next CPIM period commencing November 1, 2005, in addition to the current 2004-2005 CPIM period as proposed by PG&E.

SPURR/ABAG oppose the PG&E proposal in its entirety, claiming that PG&E is merely looking for a way to shift all of its procurement risk to its core

[8] Access, a core and noncore gas marketer, also filed a motion to intervene. Its interest in the proceeding was prompted by PG&E's hedging proposal, which was not expressly part of the initial scope of the proceeding. Access' motion to intervene is hereby granted.

customers. However, if the Commission were to grant the petition at least in part, SPURR/ABAG advocates that we impose the following restrictions:

A. Any hedging plan approved as an exception to the CPIM should cover not more than 30% of overall monthly usage during the period from November 2005 through March 2006. Since, according to PG&E's September 14, 2005 press release, PG&E already has 20% of Nov05-Mar06 usage in storage, that would result in a hedging level not to exceed 50% overall.

B. Any hedging plan approved should be limited to Nov05-Mar06 usage.

C. Any application by PG&E with regard to hedging in subsequent periods (1) must not become effective during the time period covered by the Gas Accord III Decision, and (2) must take as its scope the question of allowing and assisting core customers to manage price spike risk, including the role of core aggregators, rather than simply a narrow review of CPIM in isolation.

D. Prior to the start of each month in the Nov05-Mar06 period, PG&E must announce publicly both the level of hedging employed for that month and the weighted average hedging level. For example, PG&E could announce that "we have hedged 30% of projected commodity usage with a weighted average capped price of $1.40/therm, plus we anticipate pulling 15% to 20% of projected usage from storage."

Accent also opposes the petition, arguing that the Core Aggregation, under which core customers can elect to buy gas from providers other that the utilities, allows customers to manage price volatility. Lodi does not oppose the proposal to hedge for this winter, but recommends that the Commission reserve action on PG&E's request for authority to enter financial hedges beyond this winter until PG&E files its separate application, so as to permit the Commission to fully evaluate all of the hedging options PG&E enjoys, including physical hedges.

Coral expresses concern that PG&E proposal may not represent the most appropriate means by which to stabilize gas costs for PG&E's core procurement customers. Coral urges the Commission to encourage PG&E and the other gas utilities to enter into long-term, fixed price contracts as a part of a portfolio strategy in order to provide greater price certainty and stability for the utilities' core gas sales customers. Coral argues that this can be accomplished under the utilities' existing incentive mechanisms or through carefully considered adjustments to the incentive mechanisms.

TURN offers its "general" support for the PG&E proposal, and despite the admonition to limit comments to consideration of hedging for only the coming winter, proposes that PG&E be allowed to implement its hedging strategy for the following two years (not the four additional years proposed by PG&E). TURN is concerned that it might take too long to process a separate application for future-year hedging, but that conditions may change sufficiently by 2008 to make current hedges for years beyond that point unwise.

Discussion

The CPIM, most recently modified and approved in D.04-01-047, guides and provides financial incentive to PG&E's Core Procurement Department to achieve the lowest weighted average cost of gas (WACOG) through its gas procurement practices. The CPIM compares PG&E's WACOG to monthly gas price benchmarks. Its structure establishes evaluation criteria for PG&E's annual gas procurement costs. In applying the mechanism, the Commission adds up the allowed monthly benchmark dollars over the CPIM period and compares that sum to PG&E's actual costs for the year to determine PG&E's performance. A tolerance band around the benchmark defines the range of costs that is considered reasonable and these costs are recovered entirely from ratepayers. If PG&E's actual gas costs, as measured against the CPIM benchmark, are outside the upper (+2%) and lower (-1%) limits, PG&E shares with ratepayers the savings or losses as compared to the costs outside the tolerance band. Ratepayers and shareholders share penalties for gas costs that are above 2% on a 50/50 basis, and share savings attributed to gas costs lower than 1% of the benchmark on a 75/25 basis, between ratepayers and shareholders respectively.

In its Emergency Petition, PG&E states that "because CPIM is structured to give PG&E the incentive to procure natural gas at or below monthly gas price benchmarks, there is limited flexibility under this mechanism to fix the prices of natural gas for an extended period of time, or to expend dollars to hedge a significant portion of the Company's natural gas purchases on behalf of core gas customers." (Emergency Petition, p. 4.) Moreover, PG&E acknowledges that fact that it has hedged its core gas purchases to some extent both this year and last, but admits that the Company's risk of a major financial penalty for hedging large portions of the portfolio can be significant under the current CPIM and its authorization to hedge for multiple years is limited. Given these constraints and the potential price increases of natural gas this winter and following winters, PG&E is recommending that its hedging plan be excluded altogether from the CPIM, i.e. all costs and potential gains or losses would flow entirely to ratepayers, but that the CPIM be retained. PG&E believes that this one time change to the CPIM will accommodate the need for additional hedging.

At issue in this instance is the appropriate level of financial hedging that should be undertaken in order to protect ratepayers from price run-ups of natural gas this winter and following winters. The question the Commission needs to decide is whether hedging under the construct of performance-based ratemaking or a pre-approved hedging plan will produce the appropriate amount of hedging while at the same time aligning ratepayer and shareholder interests. This Commission has historically supported PG&E, other core-serving gas utilities, and all electric utilities to use gas price hedges in order to temper the potential increases in natural gas prices. There is little dispute that current natural gas prices are volatile, and that prices have climbed, in recent weeks, to extremely high levels. Moreover, there is no disagreement that the supply-demand balance in the natural gas market is extremely tight and that minor changes in market conditions can greatly increase the wholesale price, which is deregulated in the United States. Properly applied hedges act as insurance against the highest prices and protect consumers from the impact these higher prices have on bills. At the same time, we recognize that financial hedges can add cost, but as explained below we defer to PG&E's judgment that the protection these hedges provide far outweighs the costs.

As a matter of background, Utilities have used underground natural gas storage to meet peak winter demand. They inject throughout the injection time period from spring through fall and withdrawal during the withdrawal season from fall through winter. As SPURR-ABAG points out, current gas costs are much greater than they were just three years ago. While it is as important as ever to continually replenish core storage supplies, this form of physical hedge may no longer be enough. When supplies are tight, and there is every reason to assume that they will continue to be for some period of time, it makes sense to look for opportunities when the forecast of future prices somewhat lower and then to lock in those lower prices for a portion of the projected load through long-term contracts or price hedges.

PG&E, in this instance, has proposed a hedging plan that it believes is the most appropriate to handle potential prices increases this winter and the following four winters. TURN highlights the fact that in an environment as volatile as the natural gas market has proven to be, it is very difficult to predict which strategy is likely to be most effective in protecting core gas customers, who are likely to see record high bills under almost any scenario:

> "TURN believes that PG&E's proposal represents a rational approach to the situation, although not necessarily the only rational response. We are faced with difficult choices, none of which are especially appealing. Rather than wasting precious time debating among the various unpleasant options, TURN believes that the best approach is to act quickly to authorize the utilities to pursue whatever approaches appear best suited to their individual situations. With winter fast approaching and market volatility likely to continue for some time, there is simply no time to wait." (TURN's Response, pp.1-2)

We agree with TURN. Time is of the essence. And because financial hedges represent a small percentage of PG&E's overall cost of gas for the upcoming winter months. Protecting consumers from further price run-ups outweighs the cost of the hedges. What is missing from TURN's statement though are other measures the utility will employ to help moderate the ultimate cost of gas consumers pay. This includes but is not limited to increased energy efficiency funding, expansions of billing assistance programs, and increased consumer awareness and outreach efforts.

ORA sees the situation differently:

> "Under the PG&E application, the regulator is placed in the unenviable and inappropriate position of dealing with an application in which it has the least amount of market information to make the ultimate decision. This approach also implicitly relegates PG&E to an advisory role on matters related to its hedging plan. If advice on the hedging plan is

> ultimately what the Commission seeks, then the Commission may wish to contact Wall Street investment banks for second and third opinions before taking on the accountability for PG&E's hedging plan and exposing ratepayers to 100% of the risk. The PG&E application ultimately represents a very unfortunate turn of events given the structure and intent of the CPIM, especially given that PG&E can make (and could have already made) the decisions concerning the additional hedging request within the CPIM structure." (Opening Comments pp.6-7)

We do not believe PG&E's application has put us in an unenviable and inappropriate position. It is this Commission's responsibility to ensure that the costs passed on to consumers in the form of rates are just and reasonable. We applaud PG&E for taking the proactive step in trying to moderate what may turn out to be a winter with extremely high gas prices that will ultimately be passed on to consumers. In this case, the Commission would then be in the unenviable position of allowing these higher costs to be passed on to consumers because we did not act swiftly to approve what a utility believed were appropriate safeguards that protect consumers.

Several parties point out that there is nothing about the CPIM in its current form that would prohibit PG&E from using hedges to the extent it feels it needs to, in order to protect core customers.[9] This is simply untrue. As PG&E refutes,

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[9] As ORA points out in its comments, The Post-1997 CPIM Agreement provides the most comprehensive description of the general CPIM structure. It specifically includes a Risk Management Clause which states:

> PG&E will be allowed to trade futures, options, swaps, and other financial instruments to manage price and currency risks. These gains and losses resulting from these positions, as well as any transaction costs associated with them, will be included as a cost of

Footnote continued on next page

this sanguine view regarding the scope of PG&E's existing hedging flexibility fails to take into account the dire situation PG&E and its core customers now face, most immediately as a consequence of nationwide price increases triggered by Hurricane Katrina but also due to the highly volatile natural gas markets that have existed in recent times and that appear almost certain to continue into the future. Given PG&E's proposal to hedge the risk associated with prices this winter, we cannot reasonably put PG&E in a position in which the purchasing of additional hedging instruments could result in total gas costs to exceed the tolerance band and thus result in a large financial penalty for PG&E's shareholders. Furthermore, ORA wonders why after ten years of operation under the CPIM, including the high gas price years of 2002 and 2001 when prices at the California border at times exceeded the levels expected this winter, the inclusion of financial instruments in the CPIM now is considered to carry the risk of unacceptable penalties. ORA's position is backward looking in its argument. If there is one thing we should have learned from the energy crisis is that the market is unpredictable. Since the cost of insurance in this case is small compared to the total cost of gas the utility will eventually spend this winter and in following winters, taking proactive steps to safeguard against price run-ups is in the best interest of the ratepayers.

ORA recommends that the Commission widen the tolerance band by increasing it equally to +3% on the penalty side (from the existing +2%) and -2% (from -1%) on the savings side, giving PG&E additional flexibility or "hedge room" to make any additional hedging decisions it deems appropriate for this

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gas under the CPIM, but will not be reflected in the benchmark. (PG&E / ORA Post-1997 CPIM Agreement, IV.B., p.13) upcoming winter. This would constitute a 50% increase to the current upside tolerance band and in the current environment would provide additional protection. From an equity standpoint, given the additional risk protection, the ability to generate a reward would also be adjusted. This would be implemented for the upcoming CPIM period commencing November 1, 2005 for the 2005/2006 cycle. Any longer-term proposals or major structural changes regarding the CPIM and multi-year hedging plans can be evaluated in the context of PG&E's upcoming application.

We cannot support this approach. A widening of the tolerance band is a patch to the problem at best, but would also have unintended consequences. First of all, although widening the tolerance band would theoretically give PG&E more funding to spend on financial instruments, this proposal does not ameliorate the potential shareholder risk that PG&E seeks to avoid. Since we agree that an expanded hedging program is warranted under the current market environment, maintaining shareholder risk for hedging is not necessary because we are approving PG&E's plan up front. Additionally, widening the tolerance band could have the unintended consequence of limiting potential ratepayer savings under the CPIM by creating a higher hurdle for PG&E to achieve ratepayer and shareholder benefits through the proper management of core customer assets. Under the CPIM, reductions in gas costs beyond the tolerance band are shared 75/25 between ratepayers and shareholders respectively. ORA has not provided any support for why the potential elimination of ratepayer savings under the CPIM is a superior approach than removing the additional hedging from the CPIM for this emergency purpose. The CPIM has historically resulted in substantial ratepayer savings. The following is a summary of those savings.

CPIM Year	Ratepayer Savings
Nov00-Oct01	$29.5 million
Nov01-Oct02	$9.5 million
Nov02-Oct03	$36.4 million
Nov03-Oct04	$19.4 million (filed, not approved)

PG&E does not oppose ORA's alternative, but continues to believe that the best approach here is to remove the additional hedges from the CPIM altogether. The utility points out that the purpose of the CPIM is to align customer and shareholder risks and interests, and thereby to provide an incentive to PG&E to manage its gas purchases and storage and transportation assets to reduce total gas costs for customers and that its hedging program is a form of price insurance for core customers. PG&E argues that continuing to track hedging costs through the CPIM would create a disincentive for PG&E to acquire this "insurance," since the absolute size of the tolerance band could decrease if market prices were to drop, causing customer and shareholder risks and interest to become misaligned. In addition, by including the hedging costs in CPIM, PG&E states it would have little incentive to attempt to lower costs, since the cost of the insurance is likely to outweigh any savings achieved through the day-to-day trading of gas and management of transportation and storage assets.

TURN provides us with an alternative approach to the one proposed in PG&E's emergency application. TURN urges the Commission to approve PG&E's proposal for CPIM modifications and increased core gas hedging for this winter, but would modify PG&E's proposal to extend hedging authority beyond this winter for only the following two winters. TURN believes that it makes sense to at least begin with the initial steps of a hedging program for the next two winters (as opposed to the next four as proposed by PG&E) because current indications are that LNG may arrive on the west coast by early 2008, a development which could significantly impact current market dynamics. We see this as a rational alternative to PG&E's proposal and a superior proposal to ORA's. We believe it is high time to revisit natural gas incentive mechanisms and the treatment of hedging under them. In this regard, we agree with TURN that the Commission's current **electric** [emphasis in original] procurement policies place a much greater emphasis on hedging of future price risks than core gas procurement policy, which was established over a decade ago in a markedly different market environment.

Given the seriousness of the approaching winter, we want to encourage PG&E to make hedge investments. ORA would prefer that PG&E be more tempered in its approach by maintaining a certain level of shareholder risk. While under normal circumstances this would be appropriate, we believe that in this situation, up front Commission approval of a hedging plan along with the commitment to reevaluate how natural gas is hedged for gas procurement purposes is the more appropriate resolution. We do not believe PG&E's hedging plan as proposed is risky or contrary to the interest of the ratepayers.

For all the reasons discussed above, we will adopt PG&E's proposed winter hedging plan as modified by the TURN proposal. We do this because we believe that these two proposals, taken together, will provide PG&E's core customers with the proper amount of protection for potential winter price run-ups while maintaining just and reasonable rates.

This petition, and the response that it has generated, underscore the importance of re-examining the incentive mechanisms in light of current conditions and the potential for high gas prices over the next few years. PG&E

has indicated its intention to file an application addressing hedging over the next four years. We encourage all of our natural gas utilities to do likewise.

The Other Utilities

We thank Southwest, SDG&E and SoCalGas for offering their responses to the PG&E petition and for reflecting on hedging issues as they affect their own procurement plans for this winter. None of these utilities has asked for a modification of its incentive mechanism, although each expressed a willingness to expand its hedging activities, if that was the Commission's desire.

Southwest states that it has recently begun operating under its first GCIM cycle and that it has already implemented its hedging program for the upcoming 2005-2006 period, and thus does not recommend suspension of its existing program. Southwest's GCIM contains a "Volatility Mitigation Program" (VMP) which Southwest is recommending be increased to 50% from the adopted 25%.[10] ORA notes that in recognition of the reduced risk associated with the current VMP treatment, Southwest's GCIM contains a wider tolerance band than that of the other utility incentive mechanisms. In this context, and based on the extremely limited new information available for Commission review in the context of this expedited petition, it is not clear that there is a need to increase the scope of the VMP. Southwest already has significant shareholder protection, which should give it the encouragement it needs to pursue appropriate hedges.

SDG&E and SoCalGas filed comments together, but have different stories to tell. SDG&E has been acquiring price hedges within the confines of its

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[10] In addition to the VMP program under which Southwest undertakes hedging activities, Southwest also utilizes storage in accordance with its GCIM requirements, which serves as a further gas price hedge.

Performance-Based Ratemaking mechanism. SoCalGas has not been buying hedges, as it functions within its GCIM. Neither asks for changes to its current core procurement practices. However, both companies support a pre-approval process for natural gas hedging activities, stating:

> "In such a process the Commission can provide guidance on fundamental issues related to hedging. What does the Commission value more, low cost gas or price stability? If the answer is low cost gas, then limited hedging may be the most reasonable course of action. A portfolio of call options can be an effective way to insure customers against extreme prices. In most years, however, the vast majority of such call options will expire worthless, and the cost of hedges will simply increase the delivered cost of gas. If price stability is more important, a more robust hedging program will be called for, even if it tends to increase the overall average delivered cost of gas…"(Comments, p.4)

We encourage all of the utilities to hedge as it appears most appropriate to protect core customers. SDG&E and SoCalGas have not proposed any specific modifications to their incentive mechanism, and we will adopt none.

Assignment of Proceeding

Michael R. Peevey and Susan P. Kennedy are Assigned Commissioners and Steve A. Weissman is the assigned ALJ in this proceeding.

Comments on Draft Decision

To avoid the possibility of significant harm to the public health and welfare, this Commission must act immediately to protect PG&E's core gas customers from current high gas prices and the potential price volatility spurred by Hurricane Katrina by allowing PG&E to acquire additional price hedges for the approaching winter months. Therefore, pursuant to Public Utilities Code Section 311(f)(9), the Commission concludes that public necessity requires reduction of the otherwise applicable 30-day period for public review and comment on the draft decision, because the public interest in adopting a decision before expiration of the 30-day review and comment period clearly outweighs the public interest in having the full 30- day period of public review and comment.

Comments were submitted on October 3, 2005the necessary revisions are incorporated herein.

Findings of Fact

1. Current high gas prices and the potential price volatility spurred by Hurricane Katrina suggest that it may be appropriate for PG&E to acquire additional natural gas hedges for the approaching winter months.

2. PG&E is in the best position to determine the appropriate hedging strategy in the short time available.

3. The hedging plan we adopt today will increase the average residential monthly bill by approximately $2.00.

4. Expanding the tolerance band would theoretically give PG&E more funding to spend on financial instruments, but does not ameliorate the potential shareholder risk that PG&E seeks to avoid in order to adequately protect ratepayers.

5. PG&E proposed that PG&E's shareholders would forego any reward for the 2004-2005 CPIM year (Year 12).

Conclusions of Law

1. The Commission should approve PG&E's winter hedging plan as modified by TURN's proposal to limit it to this winter and the following two winters.

IT IS ORDERED that Decision 04-01-047 is modified to include the following ordering paragraph:

(1) To provide much-needed supplemental protection from possible dramatic natural gas price increases in the wake of Hurricane Katrina and Rita, PG&E is hereby authorized to purchase hedges in 2005. The level of the hedges and the expiration dates thereof are specified in the Gas Hedging Plan attached as a confidential Addendum to PG&E's Petition for Modification dated September 13, 2005. PG&E's hedging plan is limited to the winters of 2005-2006, 2006-2007 and 2007-2008.

(2) The costs associated with these approved hedges shall be paid by core customers. PG&E shall establish a specific core subaccount in the PGA to track these costs.

(3) All payouts associated with these hedges shall flow directly to PG&E's core gas customers in the year which the payout occurs. PG&E shall establish a specific core subaccount in the PGA to track the payouts.

(4) Neither the costs nor the payouts associated with these hedges will be shared by PG&E's shareholders.

(5) PG&E's shareholders shall forego any reward for the 2004-2005 CPIM year (Year 12).

This order is effective today.

Dated ____________, at Los Angeles, California.